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End of betterment accounting: A study of the economic, professional, and regulatory factors that fostered standards convergence in the U.S. railroad industry, 1955-1983

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THE END OF BETTERMENT ACCOUNTING: A STUDY OF THE ECONOMIC, PROFESSIONAL, AND REGULATORY FACTORS THAT FOSTERED STANDARDS CONVERGENCE IN THE U.S. RAILROAD INDUSTRY, 1955-1983

Abstract: On January 26, 1983, the Interstate Commerce Commission (ICC) announced that it would require all railroads under its regulatory jurisdiction to change from Retirement-Replacement-Betterment (RRB) accounting, to a more theoretically sound depreciation accounting for matching revenues and expenses. The change was needed because RRB did not allow for the recapture of track investment, leaving the railroads with limited capital to replace aging track lines. Over the previous three decades, it had become painfully obvious to everyone that the industry's economic woes were the result of archaic accounting procedures that lacked harmony with the rest of American accounting standards, but the ICC was reluctant to change until new tax legislation in the early 1980s forced the issue. The decision was a culmination of a debate that started in the mid-1950s when Arthur Andersen, with the help of the securities industry, began an effort to harmonize railroad and industry standards using arguments that mirror those supporting the international accounting harmonization efforts of the early 21st century.

INTRODUCTION

As the globalization of business markets grows, the debate over proper accounting standards to meet the needs of cross-border and cross-cultural investors has grown. This is especially true since the reorganization of the international standards-setting apparatus in 2001 and the creation of the International Accounting Standards Board. Even before the reorganization, the Financial Accounting Standards Board (FASB) had attempted to harmonize some of U.S. generally accepted accounting principles (GAAP) with international principles. For example, one of the intentions of SFAS 128, *Earnings per Share,* was to make "computing earnings per share more compatible with EPS standards in other countries" [FASB, 1997, para. 1]. Other U.S. GAAP that is not yet harmonized lies in the areas of accounting for research and development and for inventories. These and other accounting standards lack current convergence with international GAAP. Though the drive to harmonize international standards continues at the forefront of changing accounting thought, this debate over diverging accounting standards is not a new one.

Nearly half a century before the current international accounting standards debate, some in the accounting profession, led by Arthur Andersen (AA), felt that railroad accounting practices required by the Interstate Commerce Commission (ICC) were rapidly diverging from GAAP and, in 1955, asked for a change. It was felt that such a divergence was a major cause of the economic hardships facing the U.S. railroad industry. At the core of these divergent practices was "betterment accounting" or, more theoretically, Retirement-Replacement-Betterment (RRB). The ICC had institutionalized the practice in the early 20th century to account for "track and way structures," but it was rapidly becoming an anachronism in the face of modern depreciation rules.

In brief, AA and its allies felt that the ICC needed to phase out RRB in favor of depreciation accounting in an effort to allow the capital-starved railroads to recoup investments that, in some cases, were more than 50 years old. In addition, AA cited problems with comparable financial statements, problematic auditing procedures, and clarity as other reasons for the much-needed change. Ironically, the drive for international standards convergence is predicated on some of the same reasoning as Andersen's arguments.

The ICC and the American Institute of Accountants (AIA)[1] saw no reason to eliminate the traditional method of track accounting because it tended to keep replacement costs in line with inflation. The railroads, however, were much more prag-

[1]In 1886, the American Association of Public Accountants was formed. This organization began publishing the *Journal of Accountancy* in 1905, changing its name to the American Institute of Accountants (AIA) in 1916. In 1957, the organization became the American Institute of Certified Public Accountants (AICPA).

matic. They wanted to keep RRB due to the cost of the change and the impact such a change would have on their rate-of-return on assets (ROA), the centerpiece of ICC rate-making policy. In the face of powerful interests, the ICC refused the change.

This paper will discuss the efforts by AA and various public-interest groups to act as change agents to modernize railroad accounting principles and bring them into convergence with the accounting standards of other industries. The paper focuses on the efforts of the ICC to block such moves in light of congressional hearings and pressure from the securities industry. The article follows the debate from 1955 to the ICC's elimination of betterment accounting in 1983, using published research, news articles, and public documents, including those published by AA and the AIA.

BACKGROUND TO THE DEBATE

Betterment Accounting and the ICC: The process of changing from RRB to depreciation accounting for railroad track structures started nearly fifty years before AA's intervention. In 1906, Congress passed the Hepburn Amendment to the Interstate Commerce Act. This amendment provided the ICC with two cherished goals – the authority to set rail tariffs and the power to require uniform railroad accounting. With this newly found authority, the ICC issued revised accounting and reporting regulations. Under the new regulations, railroads were compelled to report systematic depreciation charges for equipment and other "non-permanent" fixed assets. This new methodology would be in lieu of the traditional "betterment" accounting methodology used by the rail industry.

Betterment accounting or RRB had developed over the previous 40-50 years to account for track and equipment. FASB [1983, para. 5], at the time of RRB discontinuance in 1983, defined the practice in Statement #73 explaining:

> Under RRB, the initial costs of installing track are capitalized, not depreciated, and remain capitalized until the track is retired. The costs of replacing track are expensed unless a betterment (for example, replacing a 110-lb. rail with a 132-lb. rail) occurs. In that case, the amount by which the cost of the new part exceeds the current cost of the part replaced is considered a betterment and is capitalized but not depreciated, and the current cost of the part replaced is expensed. Railroads generally have used RRB for financial reporting.

In essence, the railroad does not recoup the cost of the track until replaced. In some years, there would be no charges to current operating expenses from track usage if no track was replaced. This lack of cost recapture from RRB was indicated by the Union Pacific [Moody's Investors' Services, 1984, p. 151] that reported in 1983: "Under this method, the cost of in-kind replacements of track structure was changed to expense when incurred. Cost of betterments (improvements) to structure were capitalized and charged against earnings only when the asset was removed from service."

At the time of the 1907 change, the ICC felt that betterment accounting simply did not reflect the true cost of the railroad's operations because in lean years there would simply be no replacements or upgrades. This policy also resulted in safety concerns for the ICC and the public. With these problems in mind, the ICC designed the 1907 change to provide a more accurate rendering of these fixed asset balances through a more systematic matching of fixed expenses with revenue. As expected, the orders set off a firestorm of protest from the rail industry because it was felt that the ICC had overstepped its bounds and had jeopardized the rail industry's financial well-being.

The railroads, however, felt that they were already recognizing "physical" depreciation of their assets through the replacement process, but the ICC was pushing for a uniform application of a relatively new concept called "economic depreciation." Over the next six years, the industry attempted to get the order changed through public protests in the press, "civil disobedience" by neglecting to send depreciation reports to the ICC, and litigation. In the end, the Supreme Court in *Kansas City Southern Railway v. U.S.* [231 U.S. 423] would rule in 1913 that the ICC had the authority and jurisdiction to compel such reporting. According to AA, the court indicated that depreciation was "an inevitable fact which no system of accounts can properly ignore" [AA, 1962a, p. 128]. Though the ICC issued the equipment depreciation orders to provide more uniformity in reporting railroad income, the ruling ironically affected each railroad differently, depending on its location, age, condition of its equipment, and maintenance schedules.[2] Facing these logistical problems, the ICC compromised and did not order depreciation charges for track structures. By so doing, it institutionalized RRB for track structures as part of the Uniform System of Accounts, adopted by the ICC in 1914. In the end, the railroads lost on depreciating

[2] See Delano [1908] for a further discussion of this problem.

equipment but won on RRB for track and other structures, by far their largest asset.

The debate over RRB for track accounting began again in 1924 with the ICC issuing new preliminary orders for the railroads to begin depreciating "permanent" fixed assets. At this point, the railroads were now "bucking" established business practices. Depreciation accounting for fixed assets came into widespread use in most U.S. industries at the turn of the century, especially after the advent of federal income taxes. The ICC now wanted the railroads to depreciate track structures and take an annual charge to match revenues and expenses better. The railroads protested the ICC's decision. By 1932, a poor economy forced the ICC to relent and continue to allow RRB for track structures. Continued debate was put on hold for the next 20 years due to the Great Depression and World War II.

A Change in Economic Reality: By the 1950s, the railroads had to recognize a new economic reality in the U.S. with new transportation alternatives for travel and shipping. A fledgling airline industry had introduced pressurized cabins, making air travel more appealing to the traveling public. Cheap energy fueled the country's love of the automobile, and the newly announced interstate highway system began to hurt rail passenger service. With better roads and cheap energy, an expanding and cost-efficient trucking industry negatively impacted shipping, the "bread and butter" of the railroad's business.

The trucking industry was more cost-effective for shippers currently servicing smaller towns with "high cost," short-line railroads, spurs off the more lucrative main-stem routes. This change placed pressure on rail revenues, causing the railroads to request abandonment of these unprofitable routes as well as a general reduction in maintenance and replacements of track structures. These economic problems facing the industry soon lead to renewed questioning of the RRB system of track accounting. Safety concerns aside, this practice led inevitably to either artificially high income or low rates of return given no recapture of capital cost.

In addition to these new economic realities for the rail industry, the Internal Revenue Code in 1954 codified the use of accelerated depreciation charges for tax purposes. Because the Code still allowed companies to use straight-line depreciation for purposes of corporate reporting, the change had the effect of creating temporary tax differences for book income and tax income, requiring a deferred taxes disclosure to corporate shareholders. The ICC banned the use of deferred tax reporting for all companies under its jurisdiction, reasoning that it only allowed straight-line depreciation accounting for regulatory reporting, making it unnecessary for the railroads to deal with accelerated methods and interperiod tax allocations.

By the mid-1950s, these conflicting betterment accounting rules for some of America's largest corporations were viewed by some in the public accounting profession to be at variance with current GAAP rules and, consequently, at variance with the matching principle.[3] Over the next three decades, a number of powerful special-interest groups and governmental organizations would array against betterment accounting with the ICC and the railroads putting up a spirited, if not misguided, defense of its cherished accounting procedure.

CHALLENGES TO RAILROAD ACCOUNTING PRACTICES[4]

AA Gets Involved: In August 1955, AA petitioned the ICC asking it to modify its position on deferred taxes. The CPA firm felt that the ICC needed to address this issue because the independent auditors might be compelled to issue qualified opinions given the lack of formal adherence to GAAP in the areas of depreciation and deferred taxes. The railroads protested the desired changes because such tax deferrals threatened to increase reported (ICC) income and, in turn, negatively influence a very sensitive balance between reported income and return on investment for rate-review purposes.

During its regulatory history, the ICC, with the help of court rulings, had settled on a basic ROA methodology to determine the efficacy of a railroad's rate structure. Simply put, if the ICC felt that the ROA for a given railroad was too high in comparison with the industry and competition, it might well rule that the railroad needed to cut its passenger or freight rates. Unfortunately, the ICC often ignored the opposite condition, denying rate relief to railroads that missed their target returns. The ICC thought that this odd regulatory process was for the public good regardless of its impact on the cash flow of the railroad or future

[3]The Committee on Accounting Procedure had promulgated several Accounting Research Bulletins over the previous ten years related to the issue of depreciation charges. The first, in May 1944, was ARB 22, *Report of Committee on Terminology,* which defined depreciation as "a system of accounting which aims to distribute the cost … of a tangible asset, less salvage value over the estimated useful life of the unit…in a systematic and rational manner" [AIA, 1944, p. 179].

[4]Much of this section is derived from AA [1960, 1962a, b, 1969, 1973, 1976].

equipment replacement needs. Because of the ICC's regulatory theory, a railroad did not want its track structures subject to depreciation charges because they would lower asset balances and a corresponding increase in ROA. This myopic view of operations ignored the obvious purpose of depreciation, to recapture costs for track replacements. They did seem to understand that, due to inflation, any replacements would offset any corresponding reductions in net assets. In the end, the regulators agreed with the powerful railroads and announced in December 1956, that it would not modify its Uniform System of Accounts to incorporate interperiod tax allocations [*WSJ*, 1956, p. 2].

Leonard Spacek and the AIA Committee: In the meantime, the securities industry also became alarmed with the problems related to railroad accounting and formally began to study the issue. Corbin [1957, p. 86], quoting the *Wall Street Journal* (*WSJ*), said, "a current [AICPA] study was instigated by the New York Stock Exchange (NYSE) after consultation with the [ICC]. The exchange apparently fears that stockholders are being misled by income figures derived from the present accounting methods."

To gain a better understanding of the issues, the NYSE asked the American Institute of Accountants (AIA) to form the Committee on Relations with the Interstate Commerce Commission in mid-1956 to inquire into "clearing the principal divergencies between accounting practices of railroads and generally accepted accounting principles for other industries" [*Journal of Accountancy*, 1957b, p. 69, 1957a]. In the same article, a member of this committee, AA's Leonard Spacek, felt that these divergencies between railroad accounting and GAAP resulted in the "overstatement of current income and inaccurate property accounting." Spacek charged that railroad officials pressured the AIA committee to make sure that "no recommendations are made which would affect the railroad companies adversely from the standpoint of regulation or income." During the forthcoming congressional hearings, an ICC official would bring more "public pressure to bear by indicating dire consequences if either depreciation accounting or inter-period tax allocations were instituted." The *WSJ* [1957, p. 6] quoted Spacek as saying that he felt "the proposed accounting change would slash reported income by 20% and lead to higher rates."

Though the AIA felt the change was unwarranted, it did get the attention of members of a House Congressional Subcommittee that held hearings on the issue at the end of April 1957 after the AIA committee had issued its report.[5] In summary, the AIA committee[6] [AA, 1962b, pp. 22-23] listed six specific procedures of ICC accounting that were at variance with GAAP procedures – (1) a number of items that would normally be deferred charges or credits are reported as expenses on ICC income statements; (2) appropriations to such accounts as sinking funds are considered expenses under ICC accounting rules; (3) only income taxes paid are recognized with no interperiod tax allocations; (4) railroads are not required to provide a disclosure of the current portion of long-term debts; (5) an acquisition adjustment account is used in lieu of separate fixed asset accounts; and (6) outstanding vouchers are considered liabilities rather than an offset to cash. Concerning each of these items, an AICPA Committee did make the judgment that, "As a result [of economic changes in the industry], the principles of determining and reporting annual income to the railroad investors differ materially from those followed by other industries" [AA, 1962b, p. 5].

The AICPA committee, however, left the most contentious issue, betterment accounting, for the final part of its discussion. The committee report began this section by noting that the ICC had studied this issue of depreciation versus betterment during World War II and had required depreciation of certain properties such as buildings and other structures,[7] but that with continued railroad protests, it left betterment accounting practices intact for track structures. In a surprise to the CPA firms, the AICPA committee concluded that betterment accounting, though not in accord with GAAP, had a substantial authoritative basis and, consequently, there was no need to change to depreciation accounting. In defense of its position on track accounting, the committee [AA, 1962a, p. 125] wrote:

> … in consideration of the long history of use of replacement accounting by railroads with respect thereto, the unique nature of this category of railroad property, its relatively stable physical quantity, and the mature eco-

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[5]The congressional probe included hearings from April 30 to May 3, 1957 by the Legal and Monetary Affairs Subcommittee of the House Committee on Government Operations. The probe itself was wide ranging but focused primarily on the depreciation and tax allocation issues. The *Journal of Accountancy* [1957b] published an executive summary of the 292-page report in November 1957. The full range of the issues and arguments presented are beyond the scope of this paper.

[6]The AIA Committee Report was issued on March 28, 1957 and was published in the *Journal of Accountancy* [1957a] in May 1957.

[7]According to Boberg [1985, p. 19], the ICC required this change on June 8, 1942.

> nomic status of the industry, has concluded, … that no substantial useful purpose would be served by a change to depreciation accounting techniques in absence of evidence indicating that depreciation-maintenance procedures would provide a more appropriate charge to income for the use of such property.

The AICPA committee essentially agreed with the railroad industry and the ICC. In doing so, it developed a much broader definition of authoritative GAAP that now had its basis in historical precedent and industry usage regardless of the method's theoretical or practical basis. This was a more utilitarian approach to the way accounting principles developed and ran counter to the trend of developing a body of accounting principles based on postulates and assumptions. The AICPA would eventually attempt to institutionalize the criteria as a basis for authoritative GAAP in its 1965 publication of Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises*.

The congressional committee's responding summary [AA, 1962b, pp. 39-40] took exception to the AICPA's stance on RRB, but overall its reaction was mixed. On the one hand, the committee actually commended the ICC for putting the RRB issue on its agenda for study. But the congressional committee also vociferously complained about the ICC's "intransigence" in refusing to allow deferred taxes. In 1959, the ICC did make some changes related to the accounting variances listed by the AICPA but left intact RRB and its ban on deferred tax allocations. In the case of deferred taxes, the ICC again felt that since it required that only straight-line depreciation be used for accounting purposes, "only the actual tax payable need be recorded or a significant misstatement of current income can result because total tax would be the same under either method" [AA, 1962b, p. 10]. AA and the accounting profession had lost this round with the ICC on accounting issues, but the debate between AA and the Institute would continue for some time to come.

In another challenge to the ICC in July 1958, Spacek and AA inquired about the validity of the special language included in the auditor's report for ICC-regulated companies.[8] They felt that

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[8]The audit report language read: "In our opinion the accompanying balance sheet and statements of income and retained earnings present fairly the position of the company and results of its operations for the year, in conformity with accounting principles and practices prescribed or authorized by the Interstate Commerce Commission, applied on a basis consistent with that of the previous year" [Spacek, 1969, p. 510].

it did not fully comply with the ethics rule 5(e) of the *Code of Professional Conduct*. In a flurry of letters between the firm and the AICPA ethics committee, a brisk debate ensued with AA stating: "We have long questioned whether this form of the auditors certificate is acceptable under rule 5(e) … since it does not say whether the financial statements are in conformity with generally accepted accounting principles" [Spacek, 1969, p. 503]. In response to AA's inquiry, on March 23, 1959, the AICPA's ethics committee reaffirmed the current language of the auditor's report and did not require an explanation of the deviation between railroad accounting and GAAP because the accounting treatment had a legal or authoritative basis as prescribed by the ICC. The report went on to say that "the Institute's Auditing Procedures Committee has not spoken specifically on reports of railroads. … [and] … In absence of some authoritative statement prescribing the reporting standards for what has been concluded is a special reporting problem, the validity of any reporting practice must rest on general use and general acceptance" [Spacek, 1969, p. 510]. The language would remain for another 25 years.

Again, AA's desire for change in railroad reporting requirements was stymied, but the firm laid down some general principles in the process. First, the firm saw a need to make railroad audit reports understandable and transparent to users. Second, it felt the need to harmonize both accounting and auditing standards.

With two setbacks now, AA took a new approach in dealing with the ICC-GAAP variance problems by asking the ICC to allow the railroads and other regulated companies to publish statements in accordance with GAAP while continuing to use ICC Uniform Account rules for ICC reporting. The ICC balked at the proposal at first and issued a preliminary rule in December 1959 ordering that no ICC-reporting company could issue any type of financial statements that varied from ICC accounting rules. The proposed rule generated huge opposition from the accounting profession, securities regulators, and the NYSE. The regulators and the accounting firms felt that the ICC was attempting to exercise powers over railroad securities transactions never intended by the Interstate Commerce Act, an area of concern skirted by the congressional hearing. With the exception of the railroads, most other ICC-regulated companies, such as trucking and bus lines, protested the proposed rules because of the difficulty they would face in securing both debt and equity financing in the markets without GAAP financial statements matching revenues and expenses.

In the face of the protest from all quarters, the ICC rescinded its preliminary rule two years later in January 1962. A new rule allowed ICC-regulated companies to elect to publish GAAP financial statements with the caveat that they must make a footnote disclosure of the differences in income reported under GAAP and the ICC Uniform Accounting System. They, of course, were still required to report to the ICC using the Uniform Accounting System. As will be reported later, few ICC railroads took advantage of the new financial reporting practices options because they would have to maintain two, possibly three, sets of books. Even with the compromise, this round of the depreciation debate had ended in a draw. The CPA firms had won some reporting concessions; other regulated companies had gained some flexibility in their financial reporting; the ICC had maintained its stance on deferred taxes; and, most importantly for this story, the railroads continued to use RRB accounting for the time being. Except at AA, the issues raised by the debate began to fade from the memories of most participants.

Andersen Challenges the AICPA's Theory: In its 1969 edition of its series *Accounting and Reporting Problems in the Accounting Profession*, AA reported that it had renewed the debate over RRB with a letter to the AICPA in 1965. The correspondence was an attempt to persuade the Institute to reverse its position on betterment accounting. In 1966, the AICPA issued a response to AA. In the letter, the AICPA continued to assert that RRB accounting had substantial authoritative support (e.g., *Accounting Research Study No. 7*). Though AA's discussion did not identify the criteria on which the AICPA based its opinion, it may have been related to the criterion that read: "Each business entity must follow generally accepted accounting principles i.e. those which have substantial authoritative support in order to obtain an unqualified opinion from certified public accountants" [Grady, 1965, pp. 33-34]. Grady explained that accounting entities should, "[a] choose the accounting practices and methods of application most suitable to the needs and purposes of the entity and which,…will most fairly present the financial position and results of operations, and [b] at the same time, follow accounting practices and methods of other business entities."

The AICPA had again taken a utilitarian view of betterment accounting as it met the needs of the rail industry even though it did not harmonize with the growing body of accounting theory. The AICPA reiterated its original defense of betterment accounting as authoritative. According to Sayers [1979, p. 12], the

AICPA defense made the following points:

- It has been used by the railroad industry for many years.
- Track components are unique in nature.
- There is a relatively stable physical quantity of track industry-wide.
- The industry is mature economically.
- Current operating charges under betterment accounting approximate those under depreciation accounting given a stable program of track maintenance.

By 1976, AA had chipped away at these "justifications" and provided several criticisms of betterment accounting. The first was that betterment accounting had acted as an impediment to proper tariff rate making. Since rates are based on costs, the carrier that deferred maintenance, or did not use depreciation, could find itself failing to recoup capital through the railroad rates and, correspondingly, not having the capital to replace track structures. AA [1976, p. 151] wrote: "Had the railroads adopted depreciation accounting for the costs of grading and track structures, these costs could have been considered in the establishment or railroad rates in the past and been recovered through those rates and deducted for income taxes. This recovery of cost would have placed the railroads in a much stronger financial position today."

In fairness to AA's arguments, the ICC's rate setting was an inflexible and archaic legal and regulatory structure that did not mesh with modern capital management concepts. For example, cost behavior theories related to fixed and variable cost functions and operating "economies of scale" were virtually ignored by the ICC when determining rail tariff rates.

The next criticism dealt with the inconsistent track maintenance and replacements practices of many carriers in contradistinction to a major AICPA justification. Simply put, if a carrier elected to defer track maintenance and replacement, there were no charges against income for the use of the track in the year of deferral.[9] Decreased expense levels led to high income and correspondingly higher taxes, a frequent situation in World War II when, "railroads were generating substantial revenues but they

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[9]In a "regulatory irony," the ICC partially agreed with AA's position in a 1949 study cited by the congressional panel. The report read, "… manipulations through deferring track work is subject to some limitation because of safety requirements. Track in unsafe condition cannot be drawn from service as in the case of equipment. The ICC was treading a thin line by admitting the problem but dismissing it as unimportant because no railroad would ever leave its track in that bad of condition" [*Journal of Accountancy*, 1957b, p. 73].

could not make extensive physical replacements of track structures due to 'war shortages.' Thus, the railroads were placed in a position of paying [higher] taxes because the improper accounting procedures utilized failed to recognize the capital costs incurred to provide rail service" [AA, 1976, p. 151]. Again, this practice seemed to be one of many contradictions in the railroad industry's efforts to maintain or increase ICC tariff rate levels. In this case, a higher income probably would have resulted in a corresponding increase in the road's ROA, precluding it from getting rate relief.

Finally, the "stable physical quantity" justification cited above was also no longer valid in light of the elimination or abandonment of substantial quantities of existing track. AA felt that new technologies (e.g., air and trucking services) limited or eliminated the remaining economic life of the track structures. AA felt that betterment accounting "has led to misstatements of economic fact and have had serious adverse financial repercussions in terms of … the railroad's ability to maintain its financial strength through the recovery of its capital investment, its ability to determine the cost of providing rail service and therefore to have appropriate service rates established" [AA, 1976, p. 148]. The firm [AA, 1976, p. 152] further explained: "If depreciation that recognizes economic obsolescence is not adopted and if replacements are deferred because of an inability to obtain sufficient replacement capital, large amounts of the original capital cost of the track structures will remain on the balance sheets even though service value of the assets represented by those costs is declining."

A GAO study [1981, p. 8] also used the AICPA justification criteria. The GAO, however, concluded that the economic conditions had changed since 1957, and that betterment accounting "gives only a limited and obscure view of the effects of inflation on the railroads because it concerns only a portion of the operating cost – costs associated with track structure replacements." AA pointed out that the massive bankruptcy of the Penn Central in 1969 was, in part, due to the problems caused by ICC accounting rules that left the railroad with little capital to make replacements. Finally, AA [1976, p. 148] indicated that the "adoption of depreciation accounting will facilitate management decision making in ways including product service pricing and financial planning."

Finally, AA [1976, pp. 151-154] went on to list three benefits to depreciation accounting. The first was that depreciation accounting would "improve financial reporting, through the consistent and uniform application of these principles over all of the railroads, and would be consistent with other industries." Second, AA felt that, "depreciation accounting would facilitate proper pricing" through the recovery of fixed costs. Finally, "depreciation accounting would improve financial planning" because more consideration would be given to the levels of track structures needed and corresponding depreciation charges when dealing with economic obsolescence of the fixed assets. In the end, AA never persuaded the ICC to change either its fixed asset accounting policies or its stance on deferred taxes. However, it did set the stage for the final series of debates that would spell the end of RRB accounting.[10]

Other Voices: Except for AA's published arguments against RRB and its visible dispute with the AICPA, there was actually a dearth of published literature for or against RRB during the 1960s. This was probably due to the arcane nature of an issue everyone assumed had been settled decades ago. By the mid-1970s, only two prominent articles [Reynolds, 1964; Coleman, 1970] surfaced from the academic and professional communities that challenged the status quo.

REGULATORY REFORMS

The Railroad Revitalization and Regulatory Reform Act: In 1972, AA made one more attempt at changing the mind of the ICC regarding its accounting practices. In a December 1972 letter, the firm [AA, 1973, p. 73] suggested four benefits justifying an accounting change. The change to depreciation accounting would promote uniformity of accounting, foster cost regulation and reduce incentives to postpone retirement, improve information for regulatory purposes, and reduce the potential for the management of income.

This time AA streamlined its arguments and concentrated on issues of corporate governance and safety problems within the railroad industry. The list appears closely related to the perceived reasons for the Penn Central debacle. Norby [1981, p. 77] noted some of these reasons when he explained, "opponents of betterment accounting believe that it allows railroad manage-

[10]As a side note, during the period of time that AA was quarrelling with the ICC and the AICPA over the propriety of RRB accounting, the IRS actually was bolstering its support for the methodology through the issuance of several revenue rulings. These rulings and other tax issues related to RRB are discussed later in the paper.

ments to overstate income in periods of economic recession by curtailing track maintenance and that obscures the failing condition of such roads as Penn Central's because net income can be sustained despite deteriorating roadbeds."

It was evident from the analysis that management decision making at Penn Central and similar railroads was clouded by poorly designed and differentially applied accounting principles that allowed the financial problems of the company to be hidden. AA felt that more uniformly applied accounting principles would have helped with the Penn Central problems, especially in the areas of management decision making and regulatory actions. Though AA did report in the 1973 edition of *Accounting and Reporting Problems* that the ICC had set up an accounting study group, nothing apparently came of the endeavor. In the face of mounting criticism, the ICC "circled the wagons" and did nothing to change its accounting practices, but the economic downturns and internal financial problems that would affect the health of the rail industry were just around the corner.

To combat these problems, Congress acted by passing several pieces of legislation aimed at deregulating railroads and strengthening their financial health. The first of these was the Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act).[11] According to the Ford Library [2004], 4R Act provides for more efficient, more competitive, and thus less costly rail transportation; increases competition between various kinds of transportation and encourages a better utilization of resources by assuring that goods are transported by the most efficient means of transportation; eliminates certain antitrust immunities which permit carriers to set and hold rates at unreasonably high levels; assures that regulation provides adequate protection to consumer interests; provides needed financial assistance to the railroad industry;[12] and encourages speedy and rational restructuring of the railroads which will improve their economic health.

Babcock [1984, p. 4] points out that the Act allowed for the "variable cost of rail transport to be recognized as the minimum rate." Under these new rules, "rates equal to or greater than variable cost could not be declared 'unreasonable' unless so proven."

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[11]This legislation came on the heels of internal criticisms by the staff of the ICC itself. An article in the *New York Times* [1976, p. 2] indicated that, "the Interstate Commerce Commission's enforcement of the law has no overall purpose and concentrates on economically insignificant cases."

[12]At this time, there was a restructuring within the rail industry that saw the development of Amtrak in 1973 and the merger of a number of eastern railroads into Conrail in 1975.

This order ran contrary to the old ICC rate theory that had not always allowed for the recapture of fixed costs. In addition, the ICC could now eliminate regulation in markets where railroads had no "market power" and competed directly with other modes of transportation.

According to the 1976 *ICC Reports*, one of the lesser-known provisions of the Act was to create "a wholesale revision in the format and content of the Annual Report R-1" [ICC, 1976, p. 1598]. The new report, which was to be in effect by January 1978, was to be more proactive in nature and provide the ICC with better revenue and expense data along with "funds flow" information.[13] In addition, the ICC reported that it had conducted a new study of depreciation versus betterment accounting. To no one's surprise, it concluded: "The results of the study on the Western Maryland Railway showed that the rate base or rate of return does not significantly change by application of depreciation accounting to the track structure" [ICC, 1976, p. 1536]. This is similar to the AICPA comments from 1957 that indicated that accumulated depreciation applied to railroad structures was similar in total to replacement expenses. The ICC did comment that there were still problems with the tax consequences of betterment accounting as applied to railroads. The ICC [1976, p. 1537] now began to see that the end of betterment accounting was at hand: "Until the difficulties of changing over from betterment accounting are resolved, it cannot ascertain if such a changeover would inure to the public benefit. However, the Commission should keep apprised of the methodologies used in such matters, and conduct depreciation feasibility studies and develop depreciation schedules for various accounts."

At the end of this portion of the report, it was noted that: "[the] Coordinator recommends continued research into the updating and upgrading of the Commission's depreciation data base and the process used to analyze depreciation." Though not reported until early 1979, the ICC accepted certain revisions for railroad accounts related to provisions in the 4R Act that would go into effect in January 1978. One of the first items addressed by the new accounting regulation was railroad compliance with GAAP, an AA request from nearly 20 years prior. The new regulation quoted from the Act as requiring that accounting systems be established that "are in accordance with [GAAP] uniformly

[13]Again, the ICC was late in the application of modern accounting methodology because it had been nearly 15 years since the Accounting Principles Board issued Statement No. 3, *The Statement of Source and Application of Funds*.

applied to all common carriers by railroads subject to this part, and all reports shall include any disclosure appropriate under generally accepted accounting principles or of the Securities and Exchange Commission" [ICC, 1979, p. 125].

The 4R Act did not have the force of putting the SEC in actual control of the railroad's securities regulations, but it had the desired effect of taking most reporting requirements out of the hands of the ICC after nearly 70 years. Even with this change in external reporting, the ICC maintained its stance on RRB and as of April 12, 1977, denied a Department of Transportation (DOT) petition to change the accounting methods for track structures. The DOT, in its petition, took the position that the ICC's policies create an incentive "for railroad management to allow deterioration of fixed assets" [SEC, 1977, p. 81]. In addition, there was no mention of the ban on interperiod tax allocations but for methodology on how to deal with some "reversing timing differences."

SEC Intervention: In April 1977, the SEC finally entered the fray over the RRB issue with a docket ruling against the Burlington Northern Railroad. The SEC became concerned about a rash of accidents at the railroad and felt that part of the problem lay with lax policies regarding track maintenance and replacement. It was felt that a lack of disclosure of these policies and their effect on the company's income was hurting the investing public. The SEC ordered the railroad to make certain disclosures regarding these issues, but it did not have the ability to apply this order to deal with an industry-wide problem.[14]

The SEC again acted in May 1977 [SEC, 1977] and issued preliminary orders regarding the rail industry's deferred maintenance and depreciation disclosures. The impetus seemed to come from AA's original concerns arising from an internal rail industry report. This report commented on how replacement cycles in the industry were greater than the average useful lives of new rail and ties. This problem concerned the SEC because RRB accounting did not fully disclose replacement patterns to the shareholders and the markets and, hence, future cash outlays. Though the SEC never published final orders on this issue, it did take the railroads to task for their accounting policies and made it clear to the ICC that it needed to address these problems.

[14]File No. 3-5211, promulgated April 28, 1977

The Staggers Act of 1980: Despite the deregulation efforts begun by the 4R Act, the railroad industry struggled through high interest rates, high inflation, and the general economic recession of the late 1970s. To help mitigate the situation; Congress passed the Staggers Act, which reversed nearly a century of "rigid" regulation. It had profound effects on railroads and the ICC:

- The ICC no longer had jurisdiction over maximum rail rates unless market dominance exists and/or the rate is 180% or more of variable cost.
- As an upgrade to the 4R Act, the ICC no longer had jurisdiction over minimum rates as long as they at least covered variable cost.
- With some stringent limits, the railroads may provide contracted rates with specific carriers.[15]
- Again, as an upgrade to 4R Act, the ICC may exempt railroads from markets where they have no market power. This represented a change in rules originally designed to eliminate market sharing by railroads.
- General rate increases may be made quarterly to offset the impact of inflation.

For the railroads and the ICC, the Staggers Act created a new, free-market business environment that the railroads had not known for nearly a century. Babcock [1984, p. 6] writes: "the Staggers Act permits a great deal of pricing freedom. [To] ensure that competitive forces determine rail rates, the Staggers Act severely restricts joint ratemaking. No single-line rail rates may be discussed in rate bureaus, and joint rates may be discussed only by 'practicably participating' carriers."

In response to the regulatory reforms, Odening [1980, p. 66] reported in *Forbes Magazine* that there would be an announcement within the next 12 months that the ICC would begin to allow railroads "to capitalize some track costs and then depreciate them." The article went on to explain the now familiar refrain from the railroads that the change over to depreciation would be costly both in terms of the switch-over costs (estimated in excess of $300 million industry-wide) and in terms of higher "cash-based" taxes resulting from the new, and presumably lower, "non-cash" expenses. Finally, the report indicated that Congress was about to act to remedy the situation by legislation that would "freeze the manner in which industry taxes are calculated." Congress, in essence, was assuming that a lower

[15]This was a practice outlawed by the original Interstate Commerce Act of 1887.

tax bill for the industry would give the railroads an incentive to finance more maintenance and replacement of track. The industry had mixed emotions with respect to this assumption, but the article reported that the market was "cautiously bullish about the proposed accounting change."

The proposed legislation discussed in *Forbes* turned out to be quite different in nature than expected and came in the form of Public Law 96-613, *Miscellaneous Revenue Act of 1980*, which President Carter signed into law on the eve of his departure from office. Surprisingly, the bill turned out to be supportive of the industry's position on betterment accounting and had the effect of specifically making the methodology legally acceptable for federal income tax purposes. From the industry's myopic point of view, the need for this legislation was clear – institutionalize RRB in the tax code before it was banned.

The swift reaction of the industry to the potential accounting change reported by the ICC and supported by the Staggers Act changes showed that the railroad industry continued to have a considerable amount of political influence. Conversely, the ICC's proposed change may have been a "trial balloon," designed to galvanize industry reaction and protect RRB. In the end, the sweeping railroad regulation reforms and some partisan tax legislation seemed to have two major effects. First, it created a new environment whereby the need for an ICC now became suspect. Second, and more ironically, the law had the effect of nearly derailing accounting reforms as the ICC, now mortally wounded due to the mandate of the Staggers Act that rate targets be developed using RRB-based numbers, institutionalized RRB-tax deductions. Any new accounting reforms by the ICC seemed to be dead on arrival, but not before the IRS had its say.

The GAO Study: While Congress began debating new tax legislation for 1981, it directed the GAO to review the accounting and reporting practices of the ICC and the railroads. On February 4, 1981, the comptroller general issued a 51-page report entitled, *Accounting Changes Needed in the Railroad Industry*. The report's executive summary [GAO, 1981, p. iii] stated the following:

> In contrast to other industries, which use depreciation accounting for capital assets, railroads used a unique betterment accounting method for their track structures. GAO believes the Interstate Commerce Commission and the Securities and Exchange Commission should require railroads to adopt depreciation accounting. This would enhance the comparability of railroad's

financial reporting, assist the Congress in deliberations on regulatory reform and financial assistance to railroads, and provide better information for shippers and small investors. Railroads should also include information on their maintenance and replacement practices including deferred maintenance, in financial reports.

The three primary arguments for depreciation accounting set forth by the GAO again mirror those first brought into question by AA nearly a quarter century before. The first GAO argument for depreciation was, of course, improved expense recognition. Second, the GAO felt that it provided improved balance sheet presentation. Finally, the enhanced comparability of financial information would help Congress and other users of the information make better decisions. The new depreciation standards would help coordinate the efforts of regulators and the markets and, by extension, the management of the railroads as well, especially in the area of capital improvements and safety concerns.

Though convinced that depreciation accounting was superior, the GAO study, using data provided by the industry, pointed out the major problem that, with a change in accounting methods, there was every indication that net income would be substantially higher, as much as 35% [GAO, 1981, p. 21].[16] Higher reported net income should have been good news for any company, but for a railroad industry that had followed unsound ICC accounting practices for three quarters of a century, there would be no expense shield, leading inevitably to increased taxes and a cash outlay that struggling roads would find difficult to absorb. It was clear from the report that any change in depreciation recognition would need a corresponding change in the tax code. This lead to the GAO's response to the passage of Public Law 96-613 on December 28, 1980: "There is no reason that the railroads cannot use betterment accounting for income tax purposes and depreciation accounting for financial reporting purposes" [GAO, 1981, p. 19, fn.].

In the end, it appears that from 1976 through 1980, the ICC changed its tack to preserve betterment accounting by focusing on the presumed detrimental cash flows for the railroads. The

[16]The GAO [1981, pp. 22-23] study had to admit that the income studies came from the railroads and the ICC and were not verified for their reliability. The idea that income would be that much higher could only occur if the railroads were actually making scheduled replacements of track. Evidence pointed to the fact that this was not really happening.

ICC knew the change was coming and tried to postpone it until the actual decision was out of its hands, resulting from either a tax code change or some legal remedy. The GAO [1981, p. iv] commented that, "the ICC agrees that adopting depreciation accounting would benefit financial statement users. However, the ICC has been concerned that the accounting change would increase Federal income taxes and undermine the financial stability of even the healthiest railroads. ICC has been waiting for the tax issue to be resolved before further considering the adoption of depreciation accounting for track structures."

From a regulatory point of view, the final obstacles for the switch to depreciation were Staggers Act problems associated with the calculations of income and return targets for rate pricing based on betterment accounting data. The Staggers Act, however, turned out to be more "flexible" than anticipated, paving the way for the final changing of the accounting procedures [ICC, 1984, p. 158]. The venue for the final changes moved from the ICC and the GAO to the U.S. Congress as it debated tax legislation that would spur a faltering economy. Congress had to again deal with problems related to railroad health and, in so doing, had to address the question of tax deductions that would promote capital recovery in the industry.

TAX REFORM AND THE END OF BETTERMENT ACCOUNTING

The Early Use of RRB for Tax Purposes: Since the ICC institutionalized RRB in the early 20th century, the federal government had given tacit consent to its use of income tax assessments for businesses. For example, the U.S. Treasury Department accepted the use of RRB for determining income for tax purposes. According to Coughlan and Strand [1969, p. 24], some of the first regulations establishing RRB for track structures, when taxing authorities concurred, permitted "a reasonable allowance for the exhaustion, wear and tear, including a reasonable allowance for obsolescence, of property used in a trade or business or held for production of income."

Over the following decades, the IRS commissioner continued to support its use for tax purposes.[17] For example, Sec. 41 of the 1939 Code provided support for consistency in the general rule for methods of accounting by indicating that:

[17]See *The Chesapeake and Ohio Railway Company*, 64 TC 352 (1975) for a formal discussion of the commissioner's approval.

> The net income shall be computed upon the basis of the taxpayer's annual accounting period … in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

The Board of Tax Appeals in *Central Railroad Company of New Jersey v. Commissioner* [35 B.T.A. 501 (1937)] also recognized the commissioner's power: "[the commissioner] is given discretionary power to determine the effectiveness of the taxpayer's method of accounting for use in computing taxable net income, and, if the method does not clearly reflect the income, the statute directs him to make the computation by such method as in his opinion does clearly reflect the income."

The Supreme Court also addressed the use of regulatory accounting methods for federal income tax in the *Old Colony Railroad Company v. Commissioner* [3 USTC 880, (1932)] decision. The issue in this case related to the inclusion in taxable income of a later year part of bond premium received before March 1, 1913. The ICC required the Old Colony Railroad Company to amortize the bond premium over the respective lives of the bonds. The IRS commissioner asserted that the same treatment should apply for tax purposes. The Court did comment on the weight of ICC rulings on computing taxable income, saying that "the rules of accounting enforced upon a carrier by the Interstate Commerce Commission are not binding upon the commissioner, nor may he resort to the rules of that body, made for other purposes, for the determination of tax liability under the revenue acts."

Over 40 years after the decision in the *Old Colony* case, the Supreme Court again considered the use of regulatory accounting in *Idaho Power Co. v. Commissioner* [74-2 USTC 9521]. The Court's comments describe the attitudes of the commissioner and the railroads during the 1913-1954 period regarding the acceptance of certain accounting procedures. While the IRS commissioner was not required to accept the RRB method of accounting, he approved of its use. In the course of time, several railroad companies[18] attempted to recognize depreciation

[18]See *Central Railroad Company of New Jersey v. Commissioner*, 35 B.T.A. 501 (1937) and *Chicago and Northwestern Railway Company v. Commissioner*, 40-2 USTC 9583 (CA-7) (1940).

charges using the straight-line method on part of their property. In each case, the commissioner required the use of the RRB method. The courts decided in favor of the commissioner in each case by pointing out that taxpayer railroads had not obtained the permission of the commissioner before changing to the straight-line method.

The Commissioner's Continued Approval of RRB during the 1960s: At the same time AA and the AICPA were struggling with the theoretical underpinnings of RRB, the IRS was enhancing its recognition of the method through a series of rulings starting with Revenue Ruling 67-22 [1967-1 CB 52]. Though this ruling dealt with a narrow issue related to track welds, it did help to explain RRB's general application and, in doing so, gave a positive assent to its use. Essentially, the ruling indicated that RRB represents a rough equivalent to depreciation accounting in track.[19]

This argument bolstered both the ICC's and the AICPA's opinion that RRB had authoritative support. Two additional rulings [Rev. Rul. 70-163, 1970-1 CB 43; Rev. Rul. 73-135, 1973-1 CB 80] further defined the extent of allowable RRB deductions in lieu of a depreciation charge. Even when a railroad replaced a substantial portion of its railroad track during 1966 and 1967, Revenue Ruling 73-135 held that deductions under the retirement method resulted in a reasonable allowance for depreciation where "the taxpayer has consistently employed the retirement method of accounting and has maintained continuously a regular and consistent practice of handling retirements and replacements."

Though not explicitly mentioned, it is clear that the IRS was watching the railroads for "income management" through increasing replacements in years of higher earnings and limited replacements in low-income years, a problem that would not occur under a more traditional definition of depreciation. According to AA [1962a, p. 132], a 1931 ICC report highlighted this particular earnings management problem with RRB accounting.

[19]According to the ruling, "depreciation" comes from: [1] the cost of replacements in kind and quality less the salvage value of the materials recovered; [2] the cost of the uncapitalized portion of replacements where betterments are involved, less the salvage value of the materials recovered; [3] the capitalized cost of retirements without replacements the salvage value of the materials recovered; and [4] the labor costs incurred in retirements and replacements.

The Application of Railroad Depreciation and the 1954 Code: In 1954, a new tax code replaced the earlier 1939 edition. Regardless of the ICC's capitalization rules for railroads, the general rules for depreciation in Sec. 167(a) of the 1954 Code remained similar to those of 1939 with no specific mention of RRB. The new code, however, did have one major change; it allowed the use of accelerated methods to calculate depreciation deductions. In addition, the general rules for methods of accounting in Sec. 446(a) of the 1954 Code were also similar to 1939, providing that "taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Such language bolstered ICC claims that RRB was an accepted standard, but it left many railroads unable to recapture investment costs.

With the new code, some railroads made renewed efforts to use depreciation methods other than the RRB method for tax purposes. Several railroad companies first attempted to deduct depreciation on lines that were about to be abandoned. The commissioner rejected these attempts and required that the taxpayers continue to deduct depreciation as retirement or abandonment actually occurred. The courts sided with the commissioner regarding rails and like assets. However, some railroad companies found success in deducting depreciation for costs in the specific areas of grading and tunnel bores which, before 1969, were only deductible in the year of actual retirement. After 1968, Sec. 167(a), IRC provided for "a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)…These assets are not subject to exhaustion due to wear and tear but could eventually become obsolete."

The difficulty for the railroads was in ascertaining a reasonable and determinable useful life for the asset, a problem they would also face if RRB were ever phased out. In some cases, the taxpayers attempted to deduct depreciation of grading and tunnel bores that were placed into service in prior years based on a service life that was calculated using projected obsolescence. These cases seemed to relate to tax years beginning in the mid-to-late 1950s, ending in the early 1960s. The railroads went on to use statistical methods to predict future obsolescence.

For example, the Chesapeake and Ohio Railway (C&O) [64 TC 352 (1975)] claimed that it should be allowed to take depreciation deductions for the years 1954 through 1963 for its tunnel bores because the determinable useful lives of the assets were not more than 50 years because of foreseeable obsolescence.

The Court held that the C&O could deduct depreciation of its grading and tunnel bores over a fifty-year period and indicated that its decision was consistent with the 1969 Tax Reform Act, Sec. 185 that allowed railroad companies to amortize the cost of grading and tunnel bores first placed into service after 1968.

Using the C&O case as a guide, several railroads were successful in obtaining depreciation deductions for grading and/or tunnel bores by providing convincing evidence of useful lives.[20] By way of contrast, the Spartanburg Terminal Co. [66 TC 916, 1976, 1982] relied on the C&O decision but failed to establish a reasonable useful life for its assets and was denied a deduction for a depreciation charge. In *Burlington Northern Inc. v. U.S.* [82-1 USTC 9250], the Court of Claims also considered the issue of depreciation deductions in the mid-1950s for railroad grading and tunnel bores. The evidence provided by expert witnesses did not convince the Court as to the validity of the estimates of useful lives, and it denied the deductions. Subsequently, the Tax Reform Act of 1976 added an election to amortize pre-1969 railroad grading and tunnel bores over a fifty-year period for taxable years beginning after December 31, 1974. One consequence of the election under Sec. 185 was that it barred deductions at the time of retirement or abandonment of a railroad grading or tunnel bore. The amortization of the costs, however, would continue.[21]

The Economic Recovery Tax Act of 1981: During this time of heavy litigation over such arcane matters as tunnels bores, most railroads continued to use RRB for track structures when computing taxable income. Changes in the methodology, though, would be coming with the Economic Recovery Tax Act of 1981 that classified track structures under the Accelerated Cost Recovery System as five-year property.

Williams [1981a, p. 35], a reporter for the *WSJ*, wrote that the 1981 changes in depreciation of track structures provided

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[20]*Southern Pacific Transportation Co.*, 75 TC 497 (1980), *Kansas City Southern Railway Co.*, 76 TC 1067 (1981), *Seaboard Coastline Railroad Co.*, 54 TCM 1334 (1987), and *Louisville and Nashville Railroad Co.*, 54 TCM 1352 (1987)

[21]The Tax Reform Act of 1986 repealed Section 185 for property additions after December 31, 1986. The House Report [1986, p. 174] explained that Congress enacted the special amortization provision for railroad grading and tunnel bore expenditures in 1969 to encourage investment in light of uncertainties about the useful life of such property. The scope of the provision was extended in 1976 to cover expenditures for pre-1969 property. The committee believed that continuation of the benefit was inconsistent with tax reform.

railroads with the ability to reap substantial tax savings. An estimated $1.5 billion in tax benefits was projected for 1981 if all railroads elected the most accelerated depreciation method. The article went on to say that there was some concern that the railroads, which paid only $600 million in taxes for 1980, would not be able to use all of the deductions. Presumably, they would have been able to obtain tax refunds from prior years by carrying back net operating losses. In a related story, the *WSJ* [1981, p. 35] noted that the continuing shortsightedness hurt the rail industry by not taking full advantage of the provisions in the same tax act. The article specifically noted that the rail industry had "neglected" to order enough new rolling stock (boxcars) to take advantage of the newly "reinstituted" investment tax credit. The article then noted that, "railroad officials felt sensitive about the topic but a well-placed industry source confirms that railroads, for economic reasons, missed a chance for one type of windfall under the tax law change." The myopia of the industry and that of the regulators continued.

The ICC Ends RRB Accounting: After the GAO issued its report and before Congress passed the Economic Recovery Tax Act of 1981, the ICC announced in March 1981 that it had instructed the railroads to perform certain depreciation studies. These industry studies and others finally put the ICC on a fast track towards changing its basis for track structure accounting. Fahrenwald [1981, pp. 11, 15] reported in *Railway Age* that the ICC now "feels that the time may have arrived to do away with RRB." The article pointed out many of the same arguments against the change as the GAO report, especially in the area of higher taxes, but a Mr. Holmes, an ICC accounting systems researcher, indicated in an interview that RRB accounting:

> … is all well and good while the track is being maintained. But, if track replacements are being deferred you'll be charging too little to operating expenses. If suddenly you accelerated your replacements, you'll be charging too much to operating expense. When you replace the track, it gives recognition [in an accounting sense] to the track's deterioration. But replacement doesn't always occur in uniform manner – though deterioration usually does.

After 25 years, the ICC began to understand AA's original arguments for depreciating track structures to match revenues and expenses better. The article ended with Holmes commenting: "On [the] one hand there's a bunch of railroads that like it, but they're getting money from the government [and prefer higher earnings]. Other railroads are more concerned from a tax point. It's up to us to come to a decision separate from all that." This last point was the central thrust of the GAO's argument that depreciation needed to be required regardless of the short-term tax effects on the railroads.

After years of debate, on January 26, 1983, the Commission voted to change the method of accounting for railroad track structure from RRB to depreciation accounting. The ICC [1984, p. 158] explained, "after reviewing comments, we have decided that track structure should no longer be treated differently from other assets for accounting purposes." It went on to say: "We have concluded that, because depreciation accounting [unlike RRB] related cost consumption to the utilization of assets over time, it should be used for all assets except land." The concept of cost matching had finally taken hold. In a symbolic, last effort to defend RRB, however, the ICC report [1984, p. 158] averred: "We recognize that historical depreciation accounting fails to reflect the impact of inflation. But, depreciation accounting can be based on inflation-adjusted costs and can thereby reflect the impact of inflation." The ICC after 75 years had changed its policy but apparently not its long-held opinions.

Even though the Commission had voted for the change, it would not make the official announcement for another month. In the meantime, the *WSJ* ran several articles on the topic. In the first article, published on February 4, 1983 [*WSJ*, 1983b, p. 3], the *WSJ* mentioned that the ICC "has been trying for about four years to decide whether to let railroads use depreciation accounting for all their capital expenditures. Impetus for approving depreciation accounting came from a 1981 tax law that permitted roads to use the methods in earnings reports to the Internal Revenue Service." The article also speculated that earnings of railroads reported to stockholders could increase by as much as 20%.

In a follow-up article, Paul [1983, p. 4] reported the potential "paper profits" that the railroads would generate with the accounting change. This article included several interviews with railroad executives. Their opinion of the change varied from mild support to utter contempt. A CSX executive was quoted as saying that a railroad's "annual costs would decrease and profit would increase – but only on paper. This doesn't add one penny of cash to the railroad." The rail industry executives then slipped into their old arguments against the change and indicated depreciation accounting could "hinder efforts to secure federal approval of proposed rate increases and could force some lines to pay higher state income and property taxes." One Southern Railway executive said that, "we're going to be fair game for unions and stockholders." However, several other executives quoted in the article took a contrary view of the situation and said that depreciation accounting is probably better than existing methods because railroads would not have to continue the practice of deferring track replacement. In the end, it was hoped that investors would see the benefit of the change, "once railroads are reporting profit on the same basis as other corporations."

Finally, the *WSJ* [1983a, p. 3] announced that the ICC had indeed required the change. According to the article, the change "will boost [the] roads' reported profits." This article then attempted to explain the theoretical difference between RRB and depreciation accounting. It reported that the railroads would begin using the same depreciation accounting for track structures as they had been using for equipment costs. To this point, track improvement costs were "written off in the year they were incurred." The article then explained, "the current method results in showing higher costs within the year an investment (actually replacement) is made and thus lower profits reported to the ICC. But the adoption of depreciation accounting will have the reverse effect, reducing costs and inflating reported profits when track improvements occur." In its final analysis, the article revealed the central problem that caused the railroads to delay any change as follows:

> Under a 1981 law, railroads for tax purposes have had to use depreciation accounting for track work. Although the Securities and Exchange Commission suggested using the same approach for reports to stockholders, and to the public, only a few roads have done so. Some roads fear that doing so would boost pressure for them to raise wages and dividends and make it harder to get the ICC to approve freight rate increases. It is estimated the change will boost profits shown by railroads as much as 20%.[22]

[22]Evidence of the tax problems (in reverse) appeared as the Burlington Northern "reported net income, restated for changes in its method of oil and gas accounting, of $146.6 million, or $1.76 a share. The year-ago net, if adjusted for changes in railroad depreciation which don't require a formal restatement, would have resulted in a pro forma profit of $138 million, or $1.63 a share" [Wells, 1986, p. 1].

It appears from the article that even though the railroads were already reporting depreciation to the IRS, they were still leery of capricious ICC regulators and the market dynamics of the change. Those problems were now ending with the *de facto* deregulation of the industry. Regardless of the railroad's (and the ICC's) final opinion on RRB, the theoretical basis of the matching principle had won out after all. After 75 years of official sanction, and probably 150 years of industry usage, betterment accounting had met an ignominious end from the same bureaucratic organization that had defended it so long. With the ICC also relenting on the issue of deferred taxes in March 1983, railroad accounting finally came into harmonization with other U.S. industry practices.

THE LAST WORD

After nearly 30 years, Leonard Spacek's concerns pertaining to the "divergency" in railroad accounting principles could be put to rest. In the course of his arguments, however, he and his firm unknowingly put forth a set of principles that explained the need for the convergence of accounting standards based on clear accounting principles that would be theoretically sound, comparable between companies, transparent in their understanding, and useful for both managers and investors to use for decision making.

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